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Arizona Corporation Commission

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF
 ARIZONA WATER COMPANY, AN
 ARIZONA CORPORATION, FOR A
 DETERMINATION OF THE FAIR VALUE
 OF ITS UTILITY PLANT AND PROPERTY
 AND FOR ADJUSTMENTS TO ITS RATES
 AND CHARGES FOR UTILITY SERVICE
 FURNISHED BY ITS EASTERN GROUP
 AND FOR CERTAIN RELATED
 APPROVALS.

DOCKET NO. W-01445A-11-0310

**ARIZONA WATER COMPANY'S
 CLOSING AND RESPONSIVE
 BRIEF ON APPLICATION FOR
 REHEARING**

I. INTRODUCTION

On August 5, 2011, Arizona Water Company ("Arizona Water Company" or "the Company") filed an application for adjustments to its rates and charges for utility service furnished by its Eastern Group of water systems, including its Superstition (Apache Junction, Superior and Miami), Cochise (Bisbee and Sierra Vista), San Manuel, Oracle, SaddleBrooke Ranch and Winkleman water systems. In its application, the Company also asked that the Commission approve the Company's proposed Distribution System Improvement Charge ("DSIC") mechanism.

On February 20, 2013, the Commission filed Decision No. 73736, authorizing adjustments to the Company's Eastern Group rates. As part of that decision, the Commission authorized a 10.55 percent Return on Equity ("ROE") for the Company's Eastern Group, stating that "due to the age of some of its systems and the resulting increased

1 need for infrastructure replacement and improvement,” the Eastern Group “necessitates a
2 somewhat higher [cost of equity].” [Decision No. 73736, p. 61 at ll. 14–17].

3 Elsewhere in that decision, the Commission indicated its support for, but did not
4 authorize, a DSIC-type mechanism, and ordered that the docket remain open to allow the
5 parties to introduce additional evidence concerning the proposed DSIC mechanism. The
6 Commission also urged the parties to enter into settlement discussions regarding the
7 Company’s proposed DSIC mechanism.¹ Decision No. 73736 ended what has become
8 known as “Phase 1” of these proceedings, while the additional proceedings related to the
9 Company’s proposed DSIC mechanism have become known as “Phase 2.” After no party
10 filed an application for rehearing, Decision No. 73736 became final in all respects on March
11 12, 2013 under A.R.S. § 40-253.

12 As a result of Phase 2 settlement discussions, the Company, the Commission’s
13 Utilities Division (“Staff”) and all other parties except for the Residential Utility Consumer
14 Office (“RUCO”) and the City of Globe entered into a settlement agreement dated April 1,
15 2013. The settlement agreement provided that the Commission should authorize a DSIC-
16 type mechanism for the Company’s Eastern Group to be known as a System Improvement
17 Benefits (“SIB”) mechanism.² [Phase 2 Hearing (“P-2”) Ex. A-1]. The parties filed
18 testimony in Phase 2 on April 2, 2013 and participated in the Phase 2 hearings on April 8
19 and 11, 2013. By Procedural Order dated April 4, 2013, the evidentiary record created in
20 the underlying Phase 1 proceeding was incorporated into the Phase 2 hearing.

21
22 ¹ The Commission’s order read as follows: “Although we will not authorize a DSIC
23 herein, today, we are supportive of the DSIC type mechanism and therefore we will leave
24 this Docket open to allow the parties the opportunity to enter into discussions regarding
25 AWC’s DSIC proposal and other DSIC like proposals Staff may wish to introduce. In order
26 to allow other parties that may be interested in this issue the ability to have input, we will
27 allow such parties the opportunity to request late intervention in this Docket for the specific
28 and limited purpose of participating in proceedings addressing the two proposals referenced
in the previous paragraph.” [Decision No. 73736 at p. 104, l. 22 – p. 105, l. 3].

² Globe has since withdrawn from active participation in this matter, leaving RUCO
as the only active non-settling party.

On June 27, 2013, the Commission filed Decision No. 73938, approving the settlement agreement with certain modifications and authorizing a SIB mechanism for the Company's Eastern Group. The SIB mechanism the Commission adopted contained a five percent Efficiency Credit that the evidence showed effectively lowered the ROE on SIB plant additions by 87 basis points. As part of that decision, the Commission thoroughly considered and addressed the issue of whether the 10.55 percent ROE it authorized for the Company's Eastern Group in Decision No. 73736 should be modified. RUCO specifically argued during Phase 2 that if the Commission approved the settlement agreement, it should reduce the ROE it already authorized for the Company's Eastern Group to account for what RUCO believed to be (but presented no evidence of) "decreased risk." The Commission disagreed with RUCO in Decision No. 73938, stating that "the existence or lack of a DSIC does not change the risk of the utility, and therefore the existence or lack of a DSIC should not change the utility's ROE. . . . Logically, to the extent (if any) that a DSIC impacts risk, the reduced risk would be reflected in the sample companies used to set the ROE. . . ." [Decision No. 73938, p. 55 at ll. 11-19].

On July 17, 2013, RUCO filed an application for rehearing of Decision No. 73938 pursuant to A.R.S. § 40-253. In its application, RUCO argued that the Commission's "failure" to decrease the ROE it already authorized for the Company's Eastern Group when it approved the SIB mechanism in Decision No. 73938 was both "unlawful" and "unreasonable," and that the SIB mechanism is illegal under Arizona law. On August 15, 2013, the Commission granted RUCO's application and also reopened Decision No. 73736 for the limited purpose of "consideration of modifying the Decision [73736] concerning the determination made related to the return on equity. . . ." [Procedural Order dated August 26, 2013 at p. 2, ll. 10-11]. The rehearing has come to be known as Phase 3 of these proceedings.

Following the pre-filing of direct and rebuttal testimony by the Company, RUCO, Staff and certain intervenors, the Administrative Law Judge heard testimony on November 25 and 26, 2013 as to the limited issues on which the Commission granted rehearing. At

1 this Phase 3 hearing, the parties presented evidence concerning RUCO's assertion that the
2 Commission acted "unreasonably" by not reducing the ROE to 10.00 percent when it
3 authorized the SIB mechanism for the Company's Eastern Group. As discussed below, the
4 evidence from all three phases of this proceeding fully supports the Commission's
5 conclusion that "the just and reasonable [cost of equity] for the Eastern Group is 10.55
6 percent." [Decision No. 73736 at p. 61, ll. 3-11].

7 **II. ARGUMENT**

8 Rather than identifying any mistake or introducing any new evidence justifying any
9 change to the Commission's well-considered prior conclusions in Decision Nos. 73736 and
10 73938, RUCO's Closing Brief only repeats arguments the Commission has already
11 expressly rejected in this proceeding. RUCO ignores the fact that the evidence it presented
12 during the hearings held November 25 and 26, 2013 actually supports the Commission's
13 orders in this case. Instead, with no supporting evidence or legal support, RUCO asks the
14 Commission to reduce the 10.55 percent ROE the Commission previously considered and
15 approved twice and to repeal the SIB mechanism. Because RUCO has failed to provide any
16 basis for revising either Decision Nos. 73938 or 73736, the Company respectfully requests
17 that the Commission affirm both decisions.³

18 **A. THE COMMISSION SHOULD NOT LOWER THE COMPANY'S 10.55** 19 **PERCENT ROE BECAUSE OF THE SIB MECHANISM.**

20 **1. The 10.55 Percent ROE Is Just and Reasonable Because It Is** 21 **Necessary To Help The Company Attract Needed Capital To** 22 **Replace Aging Infrastructure For Its Eastern Group of Systems.**

23 The 10.55 percent ROE the Commission approved twice for the Company's Eastern
24 Group is just and reasonable, with or without the presence of a SIB mechanism.

25 ³ RUCO's arguments and positions have been addressed by Arizona Water Company
26 in the previous phases of this proceeding. Arizona Water Company expressly incorporates
27 by reference the pleadings, arguments, positions and evidence the Company has previously
28 presented to the Commission on these issues, in specific response to the passages of the
prior briefing RUCO cited in its Closing Brief.

1 Throughout all phases of this proceeding, the Company demonstrated that the Eastern
2 Group has unique and extraordinary infrastructure needs different than the Company's
3 Northern Group and Western Group because of "the age of some of its systems and the
4 resulting need for infrastructure replacement and improvement." [Decision No. 73736 at p.
5 61, ll. 14-17]. Compelling evidence in the record demonstrates that the Eastern Group
6 systems require extensive capital investment to repair and replace aging infrastructure. [See
7 Arizona Water Company's Phase 1 Closing Brief at pp. 4-14.] Based on this record, the
8 Commission properly recognized in Phase 1 that the Company's Eastern Group has a
9 "somewhat higher [cost of equity]," and authorized a 10.55 percent ROE. As Mr. Reiker
10 testified in the Phase 3 hearing, the Commission during Phase 1 fully considered the risk
11 associated with an equity investment in the Company's Eastern Group, and in Decision No.
12 73736 authorized an appropriate ROE based on those considerations. [Phase 3 Hearing ("P-
13 3") Ex. AWC RH-1 (Reiker Pre-filed Direct) at p. 7, l. 18 - p. 9, l. 26]. At the same time,
14 the Commission stated its support for a DSIC-type mechanism and created Phase 2 of this
15 proceeding.

16 In Phase 2, the Commission authorized a SIB mechanism for the Eastern Group in
17 Decision No. 73938. In so doing, it properly determined that "the existence or lack of a
18 DSIC does not change the risk of the utility, and therefore the existence or lack of a DSIC
19 should not change the utility's ROE. . . . Logically, to the extent (if any) that a DSIC
20 impacts risk, the reduced risk would be reflected in the sample companies used to set the
21 ROE. . . ." [Decision No. 73938 at p. 55, ll. 11-19].

22 In these Phase 3 proceedings, the Company's witnesses again testified about the
23 Company's extraordinary need to replace aging infrastructure in the Eastern Group water
24 systems and provided additional evidence supporting the Commission's approval of a 10.55
25 percent ROE to attract the capital necessary to fund the up-front costs of replacing aging
26 infrastructure. The Company's witnesses also elaborated on the Commission's prior
27 conclusions, reiterating that separate from the benefits of an appropriate ROE, a SIB
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1 mechanism is a means of addressing the problem of regulatory lag and rate shock and does
2 not reduce the risk of an equity investment beyond what may be reflected in the market-
3 based models relied upon in setting the authorized ROE. [P-3 Ex. AWC RH-1 at pp. 13-
4 16]. Following the Phase 2 hearing, the Commission properly rejected RUCO's argument
5 that the ROE should be adjusted downward in the face of a SIB mechanism:

6 We disagree with RUCO. As Mr. Olea testified, the existence or lack of a
7 DSIC does not change the risk of the utility, and therefore the existence or
8 lack of a DSIC should not change the utility's ROE (Tr. at 275 to 276). As
9 Mr. Olea explained, the efficiency credit is a more appropriate means to
provide a financial benefit to the ratepayers. (Tr. at 276 to 277). . . . [W]e are
not persuaded that any adjustment to the ROE is warranted.

10 [Decision No. 73938 at p. 55, ll. 11-20].⁴

11 In Phase 3, RUCO has failed to demonstrate that the Commission's prior conclusions
12 were incorrect or unlawful, and no adjustment to the ROE is warranted.

13 **2. The SIB Mechanism Is Not Duplicative of a 10.55 Percent ROE.**

14 In its brief, RUCO again argues incorrectly that the 10.55 percent ROE and the SIB
15 mechanism are "duplicative." [RUCO Closing Brief at p. 4, l. 4]. To the contrary, Arizona
16 Water Company, Commission Staff and the other utility intervenors repeatedly
17 demonstrated that the SIB mechanism addresses separate and distinct issues that have no
18 impact on a utility's ROE. [See Arizona Water Company's Phase 2 Post-Hearing Brief
19 dated April 29, 2013 at pp. 15-19]. At the Phase 3 hearing, Mr. Reiker highlighted that the
20 SIB mechanism addresses only the capital costs arising from a limited set of future
21 infrastructure replacements constructed between rate cases. In other words, the SIB
22 mechanism addresses the documented chronic under-earnings associated with regulatory lag
23 for a limited subset of qualifying plant additions. [P-3 Ex. AWC RH-1 at pp. 16-18]. The
24 SIB mechanism in no way provides the capital required to pay for design and construction
25 of infrastructure replacements. Indeed, the SIB mechanism does not, and cannot, provide
26

27 ⁴ As stated previously, the five percent efficiency credit included in the SIB
28 mechanism effectively lowers the ROE on all SIB plant additions by 87 basis points.

1 the up-front capital the Company requires to fund the construction of new, desperately
2 needed infrastructure. [P-3 Hearing Transcript ("Tr.") at p. 161, l. 4 – p. 163, l. 16; *see also*
3 p. 206, ll. 1-17 (Ms. Ahern confirming Mr. Reiker's explanation)]. The Company's ability
4 to raise the capital to pay for the extraordinary infrastructure replacements depends upon an
5 adequate ROE. [See Phase 1 Hearing ("P-1") Ex. A-32 (Direct Testimony of Thomas M.
6 Zepp) at pp. 42-43]. As Ms. Ahern explained in the Phase 1 hearing, the SIB mechanism is
7 only effective to the extent the Company's full cost of equity (i.e. the Commission's
8 authorized ROE of 10.55 percent) is reflected in the Company's final rates. [P-1 Ex. A-34
9 (Rebuttal Testimony of Pauline M. Ahern) at p. 29, ll. 17-20 (Ms. Ahern testifying as to
10 importance of adequate ROE in conjunction with DSIC-like mechanism); *see also* P-3 Tr. at
11 p. 232, l. 4 – p. 233, l. 2 (Mr. Walker noting that ROE in Decision No. 73736 addressed
12 significant challenges found in Eastern Group, but did not replace a SIB mechanism)].
13 Stated differently, if the Commission authorizes a SIB mechanism, but then lowers the
14 Eastern Group's authorized ROE, the Company's ability to fund the up-front construction
15 costs of much needed infrastructure replacements, including SIB-eligible projects, will be
16 impaired.

17 In fact, RUCO's own witnesses admitted under questioning by Staff that the 10.55
18 percent ROE addresses infrastructure replacement needs that the SIB does not address. [P-3
19 Tr. at p. 118, ll. 7-25 (Ralph Smith); p. 148, ll. 5-20 (David Parcell admitting that ROE may
20 apply to different plant than a SIB mechanism)]. As a result, even RUCO's testimony
21 supports leaving Decision Nos. 73736 and 73938 unchanged.

22 Utilities Division Director Steve Olea also testified that the Company's ROE should
23 not be affected by the SIB mechanism:

24 Staff believes that the granting of a SIB does not have a direct effect on the
25 utility's ability to recover or not recover its cost of service related to its test
26 year rate base.

27 [P-3 Ex. Staff RH-1 (Olea Pre-filed Direct) at p. 2, l. 13 – p. 5, l. 12]. Mr. Olea also
28 testified:

1 I believe that the SIB is not germane to the ROE that's granted by the
2 Commission for, for test year purposes, because it is, the SIB is related to
3 *future plant and future changes in plant*, not what was your normal test year,
you know, setting of rates.

4 [P-3 Tr. at p. 256, ll. 11-15 (emphasis supplied)].⁵ Staff properly considers ROE to be an
5 independent determination that must be analyzed on a case-by-case basis. [P-3 Tr. at p. 260,
6 ll. 14-18 (emphasizing that ROE and the SIB mechanism "are not related"); p. 264, ll. 10-
7 15; p. 268, ll. 6-14]. As a result, Staff continues to support the Commission's authorized
8 10.55 percent ROE *together with* the adoption of the SIB mechanism in Phase 2 of this
9 proceeding. [P-3 Ex. Staff RH-1 at p. 2, ll. 5-11].

10 Finally, as Mr. Walker pointed out, the Commission has multiple tools available to it
11 to address the various situations facing utilities in Arizona. [P-3 Tr. at p. 233, ll. 3-17]. In
12 the context of Arizona Public Service Company's ("APS") recent financial issues, the
13 Commission set higher ROEs for APS *while at the same time* authorizing multiple adjuster
14 and surcharge mechanisms to address the issues facing APS. [*Id.*] Here, the Commission
15 authorized a 10.55 percent ROE for the Company's Eastern Group following a fully
16 contested rate case based on its analysis of the risks and required rate of return for the
17 Company's Eastern Group. Decision No. 73736. After careful consideration, which
18 included a three hour oral argument on June 12, 2013, the Commission chose to approve a
19 SIB mechanism. The Commission, independent, and with full knowledge, of its ruling on
20 the SIB mechanism, properly also chose to leave its 10.55 percent authorized ROE
21 unchanged to address its findings about the unique and extraordinary need for significant
22 infrastructure replacement facing the Eastern Group.

23 **3. RUCO's Phase 3 Evidence Consists of Generalized Statements**
24 **That Are Irrelevant to the Company's Eastern Group of Systems.**

25 In Phase 3, RUCO presented two experts, Mr. Parcell and Mr. Smith, who testified
26 about the purported impact of the SIB mechanism on the Commission's authorized ROE.
27 Rather than consider the Eastern Group's specific and extraordinary circumstances, as the

28 ⁵ See footnote 4 *supra*.

1 Commission did, Mr. Parcell and Mr. Smith relied only on generalized statements and
2 irrelevant information. By presenting such evidence, RUCO invited the Commission to
3 engage in single-issue ratemaking based on evidence that has no bearing on the specific
4 facts of the Company's Eastern Group.

5 Mr. Smith did not conduct any mathematical analysis or study of the Commission's
6 authorized ROE. [P-3 Tr. at p. 89, l. 22 – p. 92, l. 15]. Rather, Mr. Smith cited to the
7 compromise 10.00 percent ROEs that the Company agreed to as part of fully negotiated
8 settlement agreements (one of which RUCO opposed) in its separate Western Group and
9 Northern Group rate cases as the sole basis for his assertion that the Commission should
10 lower the Eastern Group's ROE by 55 basis points. [*Id.* at p. 91, l. 7 – p. 92, l. 8]. The
11 Commission should reject those comparisons. Because Mr. Smith did not conduct any
12 study to address or quantify the differences between the Eastern Group system and the
13 Company's Northern and Western Group systems, Mr. Smith's comparisons of the Eastern
14 Group to the Company's other two systems are irrelevant. [P-3 Tr. at p. 96, ll. 11-15].
15 Moreover, Mr. Smith did not conduct any study to address or quantify the differences
16 between the need to raise capital or the risks associated with an equity investment in the
17 Eastern Group as opposed to the Company's Northern and Western Groups.

18 Mr. Parcell purported to provide an updated cost of equity analysis in Phase 3, but
19 admitted under cross-examination that his analysis did not examine the specific risks
20 associated with an equity investment in the Eastern Group systems (unlike the evidence
21 presented by the Company's cost of equity expert in Phase 1). [P-3 Tr. at p. 132, l. 18 – p.
22 133, l. 20]. Instead, Mr. Parcell relied on a limited discounted cash flow study and on a
23 compilation of ROEs authorized by various regulatory commissions around the country to
24 opine in a conclusory manner that any ROE exceeding 10.0 percent for any water utility
25 would be unreasonable. [*Id.* at p. 132, l. 18 – p. 133, l. 11; p. 137, ll. 13-22]. Thus, Mr.
26 Parcell testified that the Commission should *not* reduce the Company's ROE to reflect the
27 SIB Mechanism, but should reduce the ROE to reflect RUCO's biased opinion of what it
28

1 thinks the current cost of equity is for *all* water utilities. Not surprisingly, Mr. Parcell's
2 updated cost of equity analysis produces a result that is not materially different than the 9.4
3 percent ROE proposed by RUCO's original cost of capital witness in Phase 1. Such a low
4 ROE was rejected by the Commission "[a]fter considering all of the evidence presented in
5 this case, including each party's [cost of equity] estimates. . . ." [Decision No. 73736 at p.
6 61, ll. 3-11]. As Mr. Reiker pointed out, the Commission determined the appropriate cost
7 of equity at the same time it determined all other components of the Company's cost of
8 service in the Eastern Group – based on a 2010 test year. It is inappropriate for RUCO to
9 reargue its originally-proposed ROE (which the Commission rejected) simply because
10 RUCO now disagrees with the SIB mechanism that the Commission put in place. [P-3 Ex.
11 AWC RH-2 (Reiker Pre-filed Rebuttal) at p. 3, l. 10 – p. 4, l. 13]. Thus, Mr. Parcell's
12 updated cost of equity analysis is irrelevant in this proceeding and should be given no
13 weight.

14 RUCO improperly relies on the settlement agreements (one of which it opposed) in
15 the Company's Northern Group and Western Group rate cases to support lowering the
16 Eastern Group's ROE. The compromise 10.0 percent ROEs in the Western Group and
17 Northern Group settlements were the product of extensive give-and-take negotiations over a
18 wide range of issues related to different systems, in different parts of the state, involving
19 different parties at different times with different circumstances affecting utility service.
20 Accordingly, the compromise ROEs for the Western and Northern Groups *cannot* provide
21 any baseline for establishing an ROE in a separate, fully-litigated proceeding related solely
22 to the Eastern Group. The Eastern Group is a distinct group of water systems with issues
23 that differ, often markedly, from the other systems the Company operates. In fact, RUCO's
24 witness Mr. Smith acknowledged the significant differences between these groups of
25 systems when he conceded that the Commission authorized a SIB mechanism for the
26 Northern Group, but not for the Western Group, despite setting the same ROE for the two
27 groups. [P-3 Tr. at p. 109, ll. 11-20]. As demonstrated in this record, the 10.55 percent
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1 ROE the Commission authorized in Decision No. 73736 was based on the Commission's
2 determination of the appropriate cost of equity for the Company's Eastern Group, *with or*
3 *without a SIB mechanism*, given such factors as the age of the water systems and the unique
4 and extraordinary need for infrastructure replacement and improvement, consistent with the
5 testimony and evidence submitted by the Company's witnesses.

6 It is inappropriate to cherry-pick specific pieces of carefully-negotiated past
7 settlement agreements and then to employ those factors in isolation – without knowing what
8 was given up in exchange for a particular compromise – in an attempt to back into a result in
9 a different case involving a different system. Further, a party should be comfortable in
10 offering a compromise of a position in the interest of settlement at the Commission without
11 fear that those concessions will later be cited as precedent and authority against them in
12 unrelated proceedings. *See* Rule 408, *Arizona Rules of Evidence* (“conduct or a statement
13 made during compromise negotiations about the claim . . . [are] not admissible—on behalf
14 of any party—either to prove or disprove the validity or amount of a disputed claim or to
15 impeach by a prior inconsistent statement or a contradiction. . . .”); *Banker v. Nighswander,*
16 *Martin & Mitchell*, 37 F.3d 866 (2d Cir. 1994) (vacating a judgment reducing damages
17 based on plaintiff’s prior agreement to compromise the case at the lower amount, holding
18 that Rule 408 “bars the introduction of a settlement offer for the purpose of proving the
19 amount of a liability”).

20 **4. RUCO’s Own Experts Admit They Cannot Quantify Any Impact**
21 **The SIB Has on the Company’s ROE.**

22 Just as in Phase 2, RUCO on rehearing again failed to provide any evidence of what
23 an appropriate adjustment to the ROE should be as a result of the SIB mechanism. RUCO's
24 own experts repeatedly admitted that the SIB mechanism's impact on the Commission's
25 authorized ROE cannot be quantified. [P-3 Ex. RUCO RH-2 (Smith Pre-filed Direct) at p.
26 7, ll. 1-2 (impact can’t be precisely quantified)]. Under cross-examination, Mr. Parcell
27 stated as follows:
28

1 Q. Okay. Let's move on to another issue that I visited with Mr. Smith
2 about. You do not believe the impact of SIB on Arizona Water Company's
3 cost of equity can be quantified precisely, correct?

4 A. That is correct.

5 [P-3 Tr. at p. 140, ll. 19-23]. Indeed, Mr. Parcell admitted that *no one* can quantify the
6 impact of the SIB mechanism on the Eastern Group's risk and its cost of equity. [P-3 Tr. at
7 p. 144, ll. 3-8]. Thus, Mr. Parcell did not even provide a SIB mechanism-based adjustment
8 to his recommended 9.25 percent ROE, because, as he testified, he could not do so. [*Id.* at
9 p. 134, ll. 5-10].

10 Moreover, as confirmed at the Phase 3 hearing, even if a theoretical, marginal change
11 in risk related to the SIB mechanism could be calculated (which the evidence shows is not
12 possible), such a reduction is already subsumed in RUCO's ROE analyses of the proxy
13 group of water utilities the parties used in this case. As Mr. Reiker testified, Ms. Ahern
14 confirmed, and RUCO's experts admitted, all of the water utilities in the proxy groups relied
15 upon to estimate the Company's cost of equity throughout this proceeding, including Mr.
16 Parcell's, have DSIC-type mechanisms. [P-3 Tr. at p. 167, l. 21 – p. 168, l. 12 (Mr. Reiker
17 testifying that all of the proxy companies had DSIC-like mechanisms in place); p. 208, l. 2 –
18 p. 209, l. 10 (Ms. Ahern); p. 144, l. 12 – p. 145, l. 2 (Mr. Parcell)]. As a result, any analysis
19 using market data from the proxy groups of companies already accounts for the impact, if
20 any, of a DSIC-type mechanism on the cost of equity and resulting ROE. [*See* Decision No.
21 73938 at p. 55, ll. 11-20 (the Commission concluding that “to the extent (if any) that a DSIC
22 impacts risk, the reduced risk would be reflected in the sample companies used to set the
23 ROE. . . .”)]. Therefore, no adjustment to the ROE approved by the Commission is
24 appropriate.

25 **5. The Undisputed Evidence Demonstrates that Capital Costs,**
26 **Including the Company's Cost of Equity, Have Increased Since**
The Commission Issued Decision No. 73736.

27 Both Mr. Reiker and Ms. Ahern testified that Mr. Parcell's analysis ignored the
28 increases in the cost of capital that have occurred since the Commission issued Decision No.

1 73736. Ms. Ahern, the Company's cost of capital expert in Phase 3, confirmed that interest
2 rates are increasing. [P-3 Tr. at p. 201, l. 17 – p. 204, l. 6]. As a result, the Company's cost
3 of capital, including its cost of equity, has *increased* since the Commission issued Decision
4 No. 73736. [*Id.*; see also P-3 Ex. AWC RH-3 (Ahern Pre-filed Rebuttal) at p. 3, l. 21 – p. 5,
5 l. 10]. As Ms. Ahern explained, the increase in interest rates since the Commission set the
6 ROE for the Company's Eastern Group, and the resulting increase in the cost of equity,
7 demonstrates that a 10.55 percent ROE is still reasonable, if not too low. [*Id.*; P-3 Tr. at p.
8 203, ll. 4-24; see also P-3 Tr. at p. 222, ll. 6-20 (Mr. Sorenson opining that 10.55 is
9 appropriate based on all of the evidence in the record)].

10 **6. RUCO's Implication That It Will Not Appeal If the Commission**
11 **Reduces the Company's ROE is Disingenuous and Misleading.**

12 In its brief and during the Phase 3 hearing, RUCO stated that it would accept a 10.00
13 percent ROE for the Company's Eastern Group. In its Closing Brief, RUCO even implies
14 that it won't appeal a Commission decision if it reduced the Company's ROE to 10.00
15 percent. [RUCO Closing Brief at p. 6]. RUCO's statements and implications to this end are
16 disingenuous. In fact, RUCO recently appealed Decision No. 74081, in which the
17 Commission approved a settlement agreement in the Company's Northern Group rate case.
18 [*RUCO v. Arizona Corporation Commission*, No. 1 CA-CC 13-002]. In that appeal, RUCO
19 challenged both the compromise 10.00 percent ROE and the legality of the SIB mechanism.

20 In summary, the evidence in Phase 3 demonstrates that the Commission did not act
21 "unreasonably" by not reducing its previously authorized ROE of 10.55 percent when it
22 approved the SIB mechanism in Decision No. 73938. As the evidence shows, a sufficient
23 ROE is required to allow the Company to fund the large up-front construction costs
24 associated with its extraordinary infrastructure replacement needs in the Eastern Group. The
25 SIB mechanism, on the other hand, addresses regulatory lag by allowing the Company to
26 begin recovering the revenue requirement for SIB-related plant additions once those
27 replacements are placed in service, thereby also eliminating future rate shock. Contrary to
28 RUCO's arguments in its Closing Brief, the Commission thoroughly considered whether it

1 should modify the 10.55 percent ROE when it approved the SIB mechanism in Decision No.
2 73938 (as evidenced by the section titled "Return on Equity Adjustment" at p. 54 of that
3 Decision) and ultimately rejected any modification. Moreover, the SIB mechanism contains
4 a five percent Efficiency Credit that effectively lowers the ROE for SIB plant improvements
5 by 87 basis points. The Commission should accordingly reject RUCO's attempts to link the
6 SIB mechanism to the ROE, and decline to revise Decision Nos. 73736 and 73938.

7 **B. THE SIB MECHANISM COMPLIES WITH ALL REQUIREMENTS**
8 **OF ARIZONA LAW AND WAS PROPERLY ADOPTED.**

9 The parties, including the Commission's Legal Division, have thoroughly briefed the
10 question of whether the Commission has authority to adopt a SIB mechanism for Arizona
11 Water Company. The SIB mechanism that the Commission adopted in Decision No. 73938
12 complies in all respects with *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612
13 (App. 1978) because it was adopted as part of Arizona Water Company's rate structure "in
14 accordance with all statutory and constitutional requirements and, further, because [it was]
15 designed to insure that, through an adoption of a set formula geared to a specific readily
16 identifiable cost, the utility's profit or rate of return does not change." *Id.* at 535, 578 P.2d
17 at 616. RUCO adds nothing new to these arguments in its Closing Brief. Accordingly, the
18 Company respectfully requests that the Commission find once again that the SIB
19 mechanism is constitutionally permissible and consistent in every respect with Arizona law.⁶
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25 ⁶ Notably, RUCO's position with respect to the legality of the SIB mechanism is also
26 unclear. While RUCO purportedly argues that a SIB mechanism is illegal as a matter of
27 Arizona law, RUCO's Closing Brief indicates that RUCO is nonetheless willing to agree to
28 implementation of a SIB mechanism if it is somehow linked to a diminished ROE for the
Eastern Group system. [RUCO Closing Brief at 6, l. 14]. That willingness alone fatally
undermines RUCO's argument that the SIB mechanism is illegal.

1 **III. CONCLUSION**

2 For the reasons set forth above, and in the entire record of these proceedings,
3 Decision Nos. 73736 and 73938 should not be modified in any way and should be affirmed.

4 RESPECTFULLY SUBMITTED this 17th day of January, 2014.

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